Credit downgrades and fallen angels

BlackRock

Navigating credit markets in the wake of the coronavirus

Introduction

The coronavirus crisis has brought on a swift turn in the credit downgrade cycle. Through the first quarter of 2020, investment grade debt rating downgrades topped USD$400bn in the US.[1]

Similarly, volumes of fallen angel bonds—or bonds that have been downgraded from an investment grade credit rating to a non-investment grade rating—have hit USD$130bn.[2]

While historic monetary and fiscal stimulus measures have helped restore liquidity to credit markets, it remains to be seen if governments are willing or capable of providing a lifeline to businesses whose debt load was not built to withstand such an economic shock.

As we are only beginning to understand the potential long-term economic impact from the virus, we believe that this increased uncertainty can lead to both opportunities and risks for credit investors.

Going forward, we believe investors should consider defensive steps to limit the return drag that ratings downgrades can have on their investment grade portfolios. At the same time, a wave of new fallen angel bonds may provide opportunities for high yield investors if the economy begins to recover.

Tom Parker
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Tom's Take

The economic fallout from the coronavirus has caused seismic shifts across global bond markets. The sudden standstill is putting immediate stress on the revenues and earnings of many corporations.

Although many firms may be able to rely on their strong balance sheets to wait out the virus, issuers without the same reserves will likely come under increased ratings pressure. Adding additional uncertainty to the situation, intermittent fixed income liquidity issues and a freefall in energy prices may also have destabilizing effects on their business operations in the future.

Similar to previous periods of economic shock, we believe that credit investors may face a prolonged period of heighten downgrade and fallen angel activity for months to come.

In the following pages we explore the current downgrade landscape and look at two different ways to navigate credit markets given this new environment.

Thomas Parker

In the wake of the coronavirus, investors may face a prolonged period of heightened credit downgrade activity and fallen angel volumes.

Credit-screened strategies may help to reduce return headwinds caused by credit downgrades in portfolios.

A flood of new fallen angel bonds may offer an opportunity for investors who are currently rethinking their high yield allocations.

1 Source: Barclays Credit Research, "Downgrades are Piling Up", 17 April 2020. 2 Source: Barclays, Credit Research, "Not All Fallen Angels are Getting Wings", 17 April 2020.

The opinions expressed are those of the BlackRock Systematic Fixed Income Group as of May 2020 and subject to change with market conditions.

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A wave of credit downgrades

In the immediate wake of the virus, ratings downgrade activity in investment grade corporate bonds has increased significantly.

In March 2020, more than USD$400 billion of investment grade debt was downgraded at least one notch by one rating agency (Figure 1).

The monthly spike is similar in magnitude to other monthly surges during periods of market stress such as November 2008 during the Global Financial Crisis, the U.S. credit downgrade in September 2011, and the global oil sell-off in January 2016.

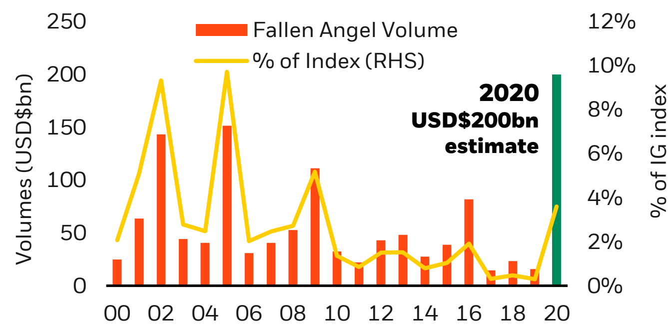
However, these downgrades as a percent of the Bloomberg Barclays US Corporate Bond Index (IG Index) outstanding, currently about 6% so far, are still lower than the most severe stressed periods we have seen historically (Figure 1). For example, November 2008 saw nearly 30% of the debt outstanding in the IG Index downgraded at least one ratings notch.[3]

Longer term, the actual pace of downgrades may change as rating agencies continue to evaluate factors including whether stay-at-home orders across the globe will have temporary or lasting economic impacts, and what low oil prices may mean for numerous industries.

> **“ …Many of these downgrade projections have not yet been priced-in. We believe a wave of this magnitude would create lagged secondary and tertiary effects…**

Figure 2: Fallen angel volumes may top highs

Fallen angel volumes and % of index outstanding



Source: Barclays Credit Research, as of 31 March 2020. Index is the Bloomberg Barclays US Corporate Bond Index. 2020 estimate is based on Barclays Credit Research.

A flood of fallen angels

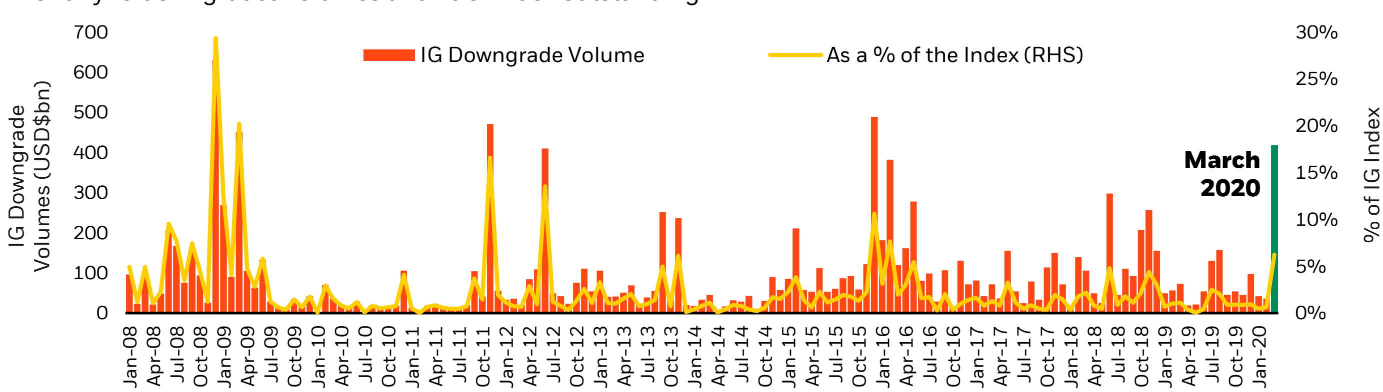
So far this year, about USD$130 of U.S. investment grade corporate debt has been downgraded to high yield, with some projecting at least USD$200bn total over the course of 2020 (Figure 2).[4] For reference, USD$200bn is equivalent to about 3.5% of the overall IG index or 7% of BBB-rated bonds in the index.[5]

On the positive side, the Federal Reserve recently announced two credit facility programs to support the high yield market. However, these programs are limited to issuers that were investment grade as of March 22nd and are U.S. based and/or have a majority of U.S. operations.

While this is stabilizing short term, some longer-term fallen angel projections are as high as USD$700bn.[6] Many of these downgrade projections have not yet been priced-in. We believe a wave of this magnitude would create lagged secondary and tertiary effects, especially in the case of a protracted recession. Fallen angel spread widening typically occurs well ahead of any rating downgrades, so we believe that investors need to start planning ahead.

Figure 1: Investment grade downgrades have spiked since the coronavirus outbreak

Monthly IG downgrades volumes and % of index outstanding



Source: Barclays Credit Research, as of 31 March 2020. After 2012, IG downgrade volumes include companies downgraded by S&P, Moody's and/or Fitch. Prior to 2012, volumes include only downgrades by S&P and/or Moody's. Index is the Bloomberg Barclays US Corporate Bond Index. Data only includes intra-index downgrades and not fallen angel bonds that have dropped out of the index. Indices are unmanaged and one cannot invest directly in an index.

3 Source: Barclays Credit Research, "Downgrades are Piling Up", 17 April 2020. 4 Source: Barclays, Credit Research, "Not All Fallen Angels are Getting Wings", 17 April 2020. 5 Source: Bloomberg Barclays Indices, as measured by the Bloomberg Barclays US Corporate Bond Index, as of 31 March 2020. 6 Source: Morgan Stanley, Investment Grade Credit Strategy, "Sizing Downgrades", 17 April 2020.

Limiting downgrade headwinds with credit screening

Downgrades have historically been a significant but sometimes overlooked risk to credit investors. While some institutional investors focus mainly on headline news about bonds that drop out of the investment grade universe and into high yield, even intra-investment grade downgrades in the highest tiers of the ratings bucket can be a significant headwind.

To illustrate, we examined the total return drivers of the Bloomberg Barclays Long AA Corporate Index—a higher credit quality index and a benchmark sometimes used by pension plans in their fixed income portfolios (Figure 3). We decompose the total returns of the index into contributions based on price appreciation and income accumulation from the index's exposure to either interest rate risk (Treasury) or credit risk (Credit). Additionally, we quantify the effect that credit downgrades of bonds out of the AA ratings bucket had on the index's return.

From this perspective, we found that the index's 8.04% annualized return was driven mostly by interest rate exposure (4.50% of Treasury income and 3.80% of Treasury price appreciation)—as expected given its longer duration and the multi-decade drop in interest rates. Returns due to credit risk exposure (1.33% of spread income and -1.18% of spread price appreciation) accounted for about 0.15% of annualized returns.

Interestingly, credit rating downgrades detracted 0.41% from total returns on an annual basis—a sizeable headwind given the high credit quality of the index.

Relative to BlackRock's long-term capital market expectations (BlackRock.com/cma) of low single digit returns annualized for investment grade credit, downgrades may represent a significant detractor that we believe does not garner enough investor attention.

Many credit investors have typically focused on yield enhancement to seek excess returns over an index. On the other hand, taking a more defensive approach that attempts to limit losses due to downgrades may be an equally important source of returns.

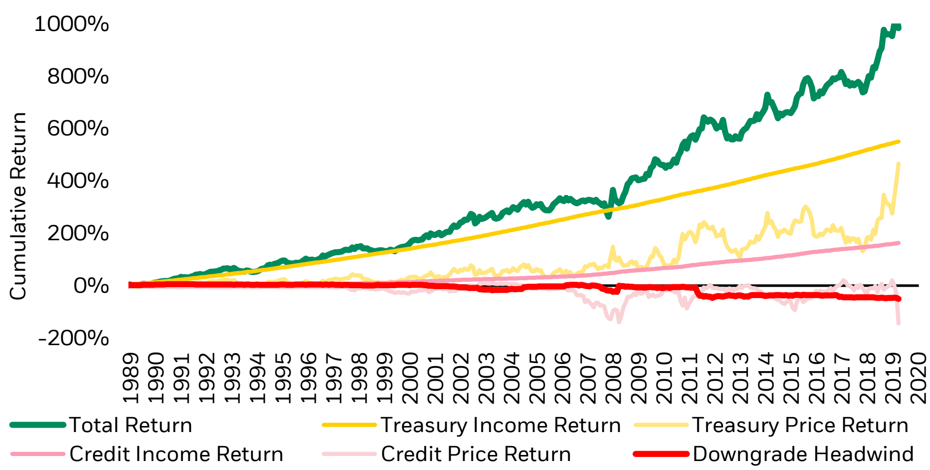
Screening out the riskiest credits

We believe credit investors looking to manage the downside risks posed by issuer downgrades can benefit from a credit screened approach. Credit screening strategies seek to invest in a broad portfolio of bonds that closely resemble a capitalization-weighted index, while removing issuers at the greatest risk of downgrades.

In these types of strategies, proprietary credit insights are applied systematically across the entire universe of credits in order to go a level deeper than traditional credit-rating agencies. By screening based on relative value, fundamental analysis, and sentiment indicators, the objective is to identify and limit exposure to weakening issuers before their bonds are repriced by the market.

In the end, a credit screened strategy seeks similar risk and return characteristics as their given benchmark index but is constructed in a way to limit the downgrade headwind risk posed by ratings deterioration.

Figure 3: Quantifying the impact of credit events on investment grade corporate bonds
Cumulative and annualized return contribution by source of the Bloomberg Barclays Long AA Corporate Index



Annualized Return Decomposition	
Treasury income return	4.50%
Treasury price return	3.80%
Credit income return	1.33%
Credit price return	-1.18%
Downgrade headwind	-0.41%
Total return	**8.04%**

The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.
Source: BlackRock, Barclays, data from 30 June 1989 through 31 March 2020. Returns represented by Bloomberg Barclays Long AA Corporate Index. For illustrative purposes only. Component contributions to return decomposition are calculated as component cumulative return divided by total cumulative return and multiplied by total annualized return. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Seek to catch fallen angel bond opportunities

We previously mentioned that some long-term fallen angel volumes have been estimated to be as high as USD$700bn.[7] For reference, the size of the high yield market at the end of March 2020 was USD$1.3tn.[8]

Fallen angel return drivers

Given a wave of downgrades of this magnitude, we believe it is important to review the unique return behavior of this niche asset class (Figure 5). The figure illustrates the behavior of fallen angel bonds in the months before and after a downgrade. Based on analysis by Barclays Credit Research, the figure gathers return behavior on bonds that were downgraded out of the Bloomberg Barclays US Corporate Bond Index since 2000.

Option-adjusted spread (OAS) is used to measure the relative performance of the bonds in the months before and after the downgrade action. To refresh, widening or increasing OAS means the value of the bonds are declining, while tightening or decreasing OAS means the value of the bonds are appreciating. To better isolate the moves tied to rating actions, the figure looks at spread changes for fallen angels relative to investment grade BBB bonds prior to their downgrade and relative to BB high yield bonds following their downgrade.

As you can see, prior to being downgraded, fallen angels show a sharp underperformance (widening OAS) versus BBB bonds. Then once they have dropped below investment grade, they have historically exhibited mean reversion with outperformance (tightening OAS) in the subsequent months compared to BB bonds.

Why have fallen angel bonds historically fallen so hard but then bounced back? There are two main historical drivers:

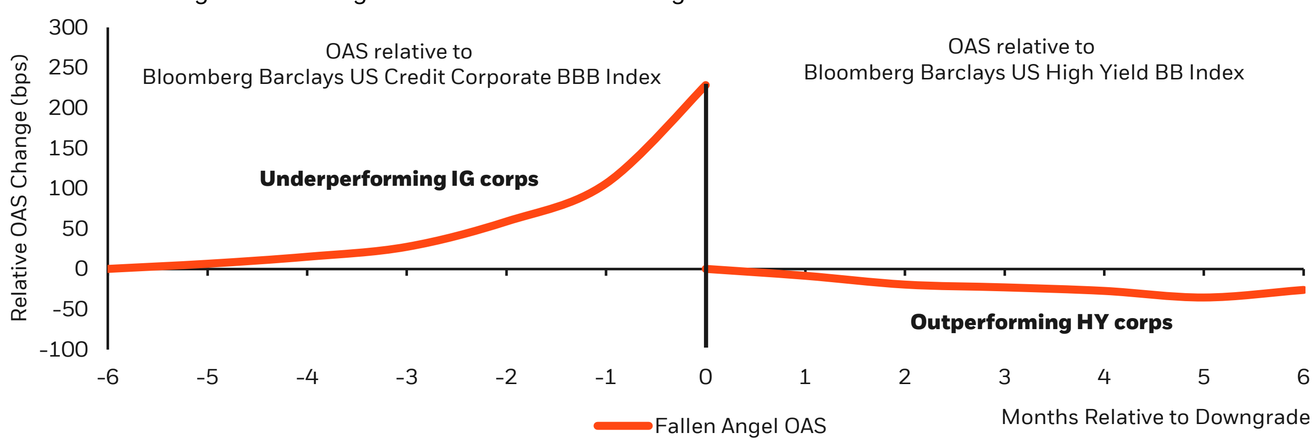
- **Price reversion following selling pressure**: It is common within investment management agreements (IMAs) to have credit quality and/or tracking error budgets. In our experience, asset owners and their designated investment manager have agreed that an investment grade bond portfolio should consist of minimal or no high yield line items. While this does not necessarily mean the portfolios are forced to sell bonds immediately at the point of downgrade, it discourages long-term high yield holdings in many investment grade portfolios. Thus, when it looks likely that a bond is going to fall below investment grade status, there is increased selling pressure by market participants who cannot hold the security, which may cause it to be oversold.
- **Upgrades back into investment grade universe**: About 85% of fallen angels are in the highest or second highest rating bucket within high yield (BB+/BB)[9], making them right on the cusp of being upgraded and repriced to investment grade. However, it is important to note that these upgrades can sometimes take several years to happen as companies would need to strengthen their balance sheets, implement significant restructuring, or wait out an economic slowdown.

Looking ahead

The need to sell a potential glut of downgraded bonds in a short period of time, combined with a limited supply of potential buyers may result in this wave of fallen angels being more oversold than in years past. Longer term, upgrades to investment grade could materialize once the virus is contained and economies can fully restart, creating an additional tailwind for the asset class.

Figure 5: Long-term performance average of fallen angel bonds

Relative OAS change of fallen angels before and after a downgrade



Source: Barclays Credit Research, report titled "Not All Fallen Angels are Getting Wings", 17 April 2020. Figure shows investment grade bonds that were downgraded out of the Bloomberg Barclays US Corporate Bond Index during the period spanning 1 January 2000 – 31 March 2020. It compares the option-adjusted spread of those bonds to the Bloomberg Barclays US Credit Corporate BBB Index in the 6 months before downgrade, and then the Bloomberg Barclays US High Yield BB Index in the 6 months after downgrade. Bonds are removed out of the index during month-end index rebalancing. Index providers delayed March 2020 rebalancing, thus downgrades that occurred in March will not be reflected until April 2020 rebalance. Fallen Angel OAS is displayed as the median change in OAS of the bonds. Please contact your BlackRock relationship manager with any questions and/or a copy of the reference document.

7 Source: Bloomberg Barclays Indices, as measured by the Bloomberg Barclays US Corporate High Yield Index, as of 31 March 2020. **8** Morgan Stanley, Investment Grade Credit Strategy, "Sizing Downgrades", 17 April 2020. **9** Source: Bloomberg Barclays Indices, as measured by the Bloomberg Barclays US High Yield Fallen Angel 3% Capped Index, as of 31 March 2020.

Conclusion

As health professionals and politicians begin discussing the 'new normal' and possible ways to safely restart economies and send people back to work, there is a growing sense that it will be a very gradual and staged process over a long period of time.

We believe this uncertainty around the speed of the recovery and the potential unforeseen knock-on effects will lead to sustained pressure on companies, making ratings migrations—both up and down—more likely in the future.

As we are only beginning to understand the potential long-term economic impact from the virus, we believe that this increased uncertainty can lead to both opportunities and risks for credit investors.

Short-term opportunity for high yield investors given a potential wave of new fallen angel bonds, and long-term risk for investment grade investors who need to limit downgrade headwinds to meet their investment objectives.

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